

Greg Stock: Why tracking the bond index could be selling you short

By Perpetual Asset Management

5 December 2023



Fixed-income investors may be missing out on exposure to corporate bonds by focusing only on benchmark funds, argues Perpetual fund manager GREG STOCK

- Bond index overweights federal and state government debt
- Opportunities for active investors
- [Find out more about Perpetual's credit and fixed income solutions](#)

Investors taking an indexed approach to fixed income may be leaving themselves over-exposed to government bonds and unnecessarily sacrificing income for the sake of defensiveness, argues Perpetual's Greg Stock.

Indexing bond and credit holdings is a popular approach for many investors who prefer allocating their active investment budget to asset classes such as equities and alternatives.

But with Australian benchmarks heavily weighted to government bonds, the index approach may not represent the best risk-adjusted opportunities.

It can mean missing the chance to rotate between sectors and parts of the yield curve, says Stock, a senior portfolio manager who heads up credit research in Perpetual's Credit and Fixed Income team.

Corporate bonds represent less than 8 per cent of the Bloomberg AusBond Composite 0+ Yr benchmark.

"The benchmark is not an investment strategy — it's just a broad composite of investment grade bonds issued," argues Stock.

"Its most common use is to measure return and risk."

Bank, property and infrastructure opportunities

Taking an indexed approach to fixed income can mean missing corporate opportunities because government bonds represent such a big part of the index, says Stock.

He says attractive opportunities are available in short-dated bank bonds, and bonds secured by assets in the property industry, as well as in residential mortgage-backed securities.

Financing the energy transition is also showing potential as banks raise capital to lend to generation, transmission and distribution assets, he says.

The big four major banks' senior bonds are less than 0.5% each of the benchmark.

A position of up to 2% in those bonds may not be unduly risky given their credit strength, argues Stock. There have been times during this very volatile 2023 when they have been cheap and a compelling opportunity, he says.

Household corporate names such as Telstra, Woolworths and Coles also issue bonds worthy of a place in portfolios at the right price, he says.

"Governments have crowded out credit issuers with their massive programs, but we see these corporate bonds having a place in an actively managed portfolio," says Stock.

Overweight struggling Victoria

State governments are among the biggest issuers of debt in Australia. But the increasingly poor position of some states' finances has hurt the index performance, says Stock.

"Victoria has struggled over the last few years with a particularly hard Covid lockdown.

"The planned repair of their structural budget deterioration has commenced but a credit rating upgrade is a long way off and their bonds have suffered since their downgrade."

Still, Victoria accounts for about 8 per cent of the benchmark Bloomberg AusBond Composite Index — a similar proportion to NSW despite the Victorian economy output being a quarter smaller than NSW.

This presented an opportunity to wait until their bonds repriced, and in the interim look at opportunities in other government bonds and in credit, Stock says.

Western Australia recovers

Stock says WA's AAA rating is an example of a turnaround story that active investors can look for and participate in.

"Five to eight years ago WA had budget challenges and had negative ratings outlooks and downgrades.

"The turnaround story after that — and a relatively less-negative Covid fiscal experience — saw the state's debt upgraded by ratings agencies.

"We invested in that turnaround story. Their bonds were cheap, they got upgraded — and that has been a large holding in the bond fund despite WA being only 2 per cent of the index."

Duration risk in the index

Stock believes for all the noise about RBA decisions, many investors underappreciate that the index is more sensitive to long-term interest rates than short-term movements in the cash rate.

"It's about knowing where your risks are to start with. Of the five years duration in the benchmark, two years is in the five-year 'belly' of the curve and two years is in the longer 10-year bucket.

"What's driving those parts of the yield curve is sometimes different to what's driving the cash rates.

"Since the market was pricing in the RBA cutting — not raising — rates this year, that was an opportunity to go short in the short end of the curve.

"Our yield curve slope is traditionally measured between 10yr rates and 3yr rates, and while it did not invert this year, it got to zero and had a large 60bp range.

"There have been curve-positioning trade opportunities during the year for active investors. "

Active, diverse approach

Stock says some investors have been caught out recently by becoming reactive to short-term trading opportunities driven by macro-economic events.

"They end up selling things when they should be holding and not buying when assets are cheap.

"Ultimately what we're trying to do is buy low, sell high in a risk-adjusted framework that helps our investors.

"There are sector and duration concentrations and risks implicit in bond benchmarks. These can present opportunities which experienced active managers can navigate.

"That's why an active, diverse approach is the best way to get a balanced return."

About Perpetual's Credit and Fixed Income team

Perpetual offers a range of cash, credit and fixed-income solutions and are specialists in investing in quality debt.

We take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Find out more about [Perpetual's Credit and Fixed Income capabilities](#)

Want to find out more? [Contact a Perpetual account manager](#)

This article has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426, as the issuer of the Perpetual Diversified Income Fund ARSN 601 199 035 (Fund).

It is general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. The information is believed to be accurate at the time of compilation and is provided in good faith. It may contain information contributed by third parties. PIML does not warrant the accuracy or completeness of any information contributed by a third party.

Forward-looking statements and forecasts based on information available at the time of writing and may change without notice. No assurance is given that the forecast will prove to be accurate, as future events may impact actual results and these could differ materially from those anticipated. Any views expressed in this article are opinions of the author at the time of writing and do not constitute a recommendation to act.

The product disclosure statement (PDS) for the Perpetual Diversified Income Fund, issued by PIML, should be considered before deciding whether to acquire or hold units in the Fund. The PDS and Target Market Determination can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au.

No company in the Perpetual Group (Perpetual Limited ABN 86 000 431 827 and its subsidiaries) guarantees the performance of any fund or the return of an investor's capital. No allowance has been made for taxation and returns may differ due to different tax treatments. Past performance is not indicative of future performance.